FOMC NOTES
July 12-13, 1983
Paul Meek

Open market operations over the past seven weeks sought to foster the slight increase in reserve restraint which the Committee voted on May 24 and reaffirmed in the telephone consultation of June 23. As noted in the regular reports, the period was characterized by a quickening of monetary aggregate growth, relative to expectations at the May meeting.

In its operations over the interval, the Desk encountered a willingness by banks to borrow at the discount window as reserve restraint increased, as well as changing market views of the Federal Reserve's policy stance, which fed back on bank behavior. The persistent tendency of borrowing to run high, in part, reflected higher-than-expected levels of excess reserves. But banks also turned to the window with enthusiasm to borrow at the 8-1/2 percent discount rate as the federal funds rate rose. Such a tendency is not unusual in a period when most banks have clean records. Borrowing by non member banks and seasonal borrowing rose a bit and wire problems also led to occasional recourse to the window.

Early in the period, the Desk was slow to supply reserves in the week of Memorial Day in order to allow the System's slightly more restrictive stance to be reflected quickly in the money market. The federal funds rate did move up to 8-3/4 percent or a bit higher rather promptly. We were then caught a bit by surprise when the

Bank borrowed from the discount window on Thursday, June 9, about a week earlier than expected and only a day after we had bought $1 billion of Treasury bills to supply reserves seasonally. But we reversed direction with 3-day matched transactions the following Monday, allowing a rather tight market to emerge on the last date of the June 15 week without our intervention.

In this and the following week, we erred on the side of caution because of the further strengthening of the monetary aggregates, while excess reserves continued to exceed path levels. Adjustment and seasonal borrowing at the window rose well above the $350 million level incorporated in the path, and the federal funds rate moved up above 9 percent. Some of this tautness evaporated in the June 29 week, when non money market banks stepped up their use of the discount window. (Coincidentally, this was after the Committee's consultation affirmed a $400 to $500 million range for borrowing.) A measure of tautness was restored last week over the statement date and July 4 weekend, and federal funds have been trading around 9-1/8 percent in the current week.

Some analysts were slow to identify the System's shift of emphasis. They explained away the tightening of money market conditions as seasonal, in effect interpreting the rise in discount window borrowings and the federal funds rate as a consequence of a seasonal demand for excess reserves. Since market analysts tend to focus on net reserve positions, the high levels of excess reserves often exceeded adjustment borrowing at the window to produce a net free reserve number.

The financial markets moved to considerably higher yields during the intermeeting period, despite some backing and filling. However analysts read the numbers, traders prepared for a higher federal funds rate and increased supplies of Treasury issues. The federal funds rate has risen about 50 basis points since the May meeting and 70 basis points since early May. Changed expectations as well as increased reserve restraint contributed to the rise. Rates on Treasury bills rose from about 60 basis points for 3-month bills to 90 basis points for 6 to 12-month maturities. Banks stepped up CD issuance in June as they moved away from anticipating further rate declines. But there was good demand for such paper at narrow spreads against Treasury bills, given the previous fall in CDs outstanding made possible by MMDA inflows. The rise in CD rates to about 9-1/2 percent for three-month maturities has put considerable upward pressure on the prime rate, but thus far the competition for loans in a slack market has seemed to reinforce political reasons for not raising the prime rate.

Prices of Treasury notes and bonds have fallen significantly over the interval, responding to an abundance of supply, the rise in the fed funds rate, and a stronger economic outlook. In the past seven weeks the Treasury raised $26 billion of new cash from coupon issues, in addition to $10 billion from Treasury bills. Three weeks ago, just before the quarter-end financing, yields rose abruptly as the market probed for levels that would entice investors to buy. In the event dealers underwrote the Treasury issues but yields had to rise even higher before customers were willing to buy. There was a crescendo of dealer anxiety before the securities finally were placed with prices at levels that discounted a fed funds rate of perhaps 9-1/2 percent over the near term. The market has stabilized since in a lower trading range with yields ranging 75 to 100 basis points higher than on May 23 for intermediate securities and about 70 basis points higher for 20- to 30-year issues.

The market's skittishness reflected a realization that the sheer volume of Treasury financing calls for finding an ever-widening circle of buyers. Estimates of the Treasury's cash needs in the next six months range up to $115 billion-indicating a need to raise almost $4.5 billion of net new cash each week. There will be unremitting pressure in the coupon sector. The New York staff estimates that the Treasury will sell $60 billion of coupon issues in the third quarter against maturities of $23 billion. The Treasury estimates its needs will be a few billion dollars less. The conflict between the demands of the Treasury and those of an expanding economy does not seem as far away as it did a few months ago.

In the corporate bond market, yields have risen about in line with Treasury issues but the pace of new offerings has receded. Treasurers have kept their offerings on a well-stocked shelf, hoping that a window of lower rates will appear some time over the next six months. Meanwhile, they have been able to raise money in the stock market, from banks, or from internal sources. But a decline of rates from current levels would probably trigger a substantial flow of issues to market. The municipal market has performed rather well in relation to other markets as the bulge in issues sold to beat the June 30 deadline for bearer bonds passed; yields rose about 25 basis points. The much publicized difficulties of the Washington Public Power Supply System adversely impacted some power related issues but not the market as a whole. Still, increased supply and the "WHOOPS" situation appear likely to pose problems for the market as we go forward.

As noted in the regular weekly reports, we suspended trading with the Securities Groups New York Hanseatic Division on May 31, in view of the merger on June 1 of its activities with a savings and loan association owned by The Securities Groups--without requested prior approval. The dealer was dropped from the reporting list on June 6. A review of its past performance, and current operations and financial structure is continuing. In addition, the

Federal Home Loan Bank Board is expected to make a formal ruling on the permissibility of such activities for an S&L.

FOMC Briefing
Long-run Targets
S. H. Axilrod
7/11/83

As noted in the blue book, the principal issue for the Committee in reassessing the longer-run ranges for 1983 appears to revolve around M1. So far as we can see there appears to be little chance of coming close to the present 4 to 8 percent 1983 range for that aggregate by year-end without a more rapid rise in interest rates than contemplated in any of the short-run operating alternatives presented for this meeting. Thus, we have shown in the blue book an alternative longer-run range for M1 of 7 to 11 percent which seems more practicable, particularly if the Committee adopts a policy course that entails <u>some</u> rise in interest rates over the balance of the year. It could be argued that an 8 to 12 percent range would be even more practical; such a range would be more likely to accommodate a policy course that did not necessarily involve further interest rate increases.

It must be recognized, however, that substantial elements of uncertainty still surround M1. Our recent research suggests that M1 has become more responsive to interest rate changes as regular NOW accounts have become a relatively more important component. That would suggest that a small rise of market interest rates would place greater restraint on M1 than it had in the past. Yet actual demand for M1 over the past three quarters (given income and interest rates) has run even stronger than our new M1 equation suggested, even though the equation itself was generating what seemed to be unusually strong demands. So there still appears to be some question about whether we have much of a handle on M1 demand. Moreover, that demand should in any event be in process of changes if and as super-NOW accounts assume a more important role, which would act to reduce the responsiveness of M1 to market interest rates over time from what it had recently been.

None of this would deny that there is a small chance that M1 growth could decelerate very substantially over the balance of the year. But that would seem to depend on holders of regular NOW accounts shifting funds out without much lag in response to small interest rate increases and to holders of demand deposits finding that the surprisingly strong and sustained build-up in such accounts over the past several months (excepting January and February) has brought these balances to levels that are more than ample for transactions and compensating balance needs. The greater odds are on a relatively moderate deceleration in M1 growth over the balance of the year, accompanied to be sure by the probability of some increase in the income velocity of M1 after several quarters of decline.

Whether such a possible return to slightly more "normal" behavior of M1 velocity is sufficient to give that variable more weight in operations than has been the case since last fall is, of course, another major question. Despite the recent apparent tendency for velocity of M1 to become less negative and perhaps turn positive, its demand properties, as I mentioned earlier, are still rather uncertain--at least as judged from model results, including the variety of different results one can get from different models. On the other hand, nominal GNP was stronger than earlier expected in the second quarter of this year and seemingly will be so in the third quarter. The strength of nominal GNP in the second and third quarters, not to mention earlier quarters, is considerably less than most monetarist-type models would have predicted (since they would probably not have taken account of a structural downward shift in velocity), but the strength of M1 did to some extent foreshadow the surprisingly strong nominal income growth of the past quarter and this one and to some degree is also probably reflecting growing transactions needs on a current basis.

Against that background, we have made an effort to suggest possible alternative language for the directive should the Committee wish to give more weight to M1. Because of the inherent demand uncertainties that are probably still with us, I am afraid the proposed language necessarily is not much clearer than the existing language indicating the Committee will monitor M1 with its weight dependent on more predictable velocity characteristics.

There seems to be little reason, Mr. Chairman, to alter the 1983 ranges for the broader aggregates. The proposed directive provides optional language for consideration that indicates an expectation that these aggregates may be in the upper part of their ranges. Our models do not make me much, if any, more comfortable about predicting M2 than M1, but that optional language may better fit a policy approach that looks to unchanged (or declining) interest rates over the balance of this year than one that contemplates some rise in rates.

The options laid out in the blue book for 1984 are pretty much self-explanatory. It seems probable that modestly lower growth in the broader aggregates next year relative to this will in practice be consistent with continued relatively good economic recovery, given the projected moderateness of wage and price pressures. Whether the tentative growth ranges for 1984 should as a matter of policy be lowered from 1983 at this time would seem to depend as well on assessment of the contribution that such a reduction could make to holding down wage and price pressures as the recovery proceeds and the fiscal stimulus gets larger.

M1 growth in 1984 should be considerably slower than in 1983, but there is a small chance that it will not. On the face of it, considerably slower growth than this year should naturally be expected since the upward stock adjustment of M1 balances in late '82 and the early part of '83 to a much lower level of interest rates will have been behind us for some time. On the other hand, if the current economic recovery is not as sustainable as projected at the continuing apparently fairly high level of real interest rates, one would have to assume either that price increases will be strong next year or nominal interest rates will be lower. If the latter should be the case, M1 growth could again be strong as short-term rates move down further toward NOW account ceiling rates.

NOTES FOR THE F.O.M.C. MEETING
July 12, 1983

Sam Y. Cross

Over the period since your last meeting, the dollar has continued to strengthen about 2 to 4 percent against most of the European currencies and the Japanese yen. Against the traditionally strong currencies like the German mark and Swiss franc, the dollar is now back to the highs reached last November. Against some of the weaker currencies, the dollar has set new records. On a trade-weighted basis, the dollar reached an all-time high in mid-June and is at about that level now. It stands some 7 percent higher than the level at the beginning of this year.

The major factor behind the dollar's strength over this period has been the changing outlook for interest rates. In May and early June the exchange markets' hopes for further declines in U.S. interest rates faded, and then gave way to expectations of renewed increases in response to growing evidence of a robust recovery in the U.S., together with large actual and prospective federal budget deficits and rising money supply. In other countries, expectations that interest rates generally would continue to decline persisted longer than in the United States, and interest differentials favoring the dollar widened.

The current strength of the dollar apparently reflects anticipation of a possible tightening of U.S. monetary policy. Nevertheless, there were occasions particularly in late June when there was enough skepticism about how long the dollar would maintain these levels that it came off rather sharply though briefly on adverse news. Skepticism was generated by figures published during June suggesting a faster deterioration in the U.S. trade position than had been anticipated. At the same time, large trade surpluses were again reported for Germany and Japan. The prospects for financing a widening U.S. current account deficit came more into question with publication of statistics for May showing a slowdown in capital outflows from Germany and Japan. Also during this time, there was some evidence of at least occasional shifts of funds back into Germany and Japan, and there was less talk of foreign inflows into U.S. securities.

At the present, therefore, the exchange market seems to be reflecting a short-term focus on interest rate prospects, although we may see more medium-term concern about the outlook for our balance of payments and its financing.

On July 26, 1983, the last Carter bond to mature will be redeemed. The Treasury intends to use marks warehoused with the System to cover this repayment, thereby eliminating all balances warehoused for the Treasury.

FOMC Recommendations

Mr. Chairman, swap drawings totaling $269 million by Mexico under the Federal Reserve special swap arrangement will mature between now and September 2, 1983. Of these, $115.5 million mature before August 23, 1983. I would propose that these drawings, $14 million of which comes up for first renewal and $101.5 million for second renewal, be extended to August 23, 1983. Mexico fully intends to repay these and all other drawings under the special swap arrangement on the maturity date. Indeed, the possibility is being explored of their making a deposit or investment of $500 million in anticipation of repayment of the BIS-U.S. credit arrangements.